

**MEMO# 20311**

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## **SEC Approves Executive Compensation Disclosure Revisions, Seeks Comment on Modified Proposal Relating to Non-Executive Employees**

©2006 Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice. [20311] August 25, 2006 TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 24-06 SEC RULES COMMITTEE No. 37-06 SMALL FUNDS COMMITTEE No. 20-06 RE: SEC APPROVES EXECUTIVE COMPENSATION DISCLOSURE REVISIONS, SEEKS COMMENT ON MODIFIED PROPOSAL RELATING TO NON-EXECUTIVE EMPLOYEES The Securities and Exchange Commission has approved extensive revisions to its rules governing the disclosure of executive and director compensation, related party transactions, and corporate governance matters.<sup>1</sup> The revisions were adopted substantially as proposed. Section I of this memorandum briefly summarizes the revised rules, including those that affect disclosures by registered investment companies. Funds must comply with the revised rules in registration statements and proxy statements filed with the SEC on or after December 15, 2006. The SEC also has modified its proposal relating to the disclosure of compensation information for certain non-executive employees. The SEC is seeking comment on the modified proposal, which is discussed in Section II of this memorandum. Comments on the modified proposal are due to the SEC 45 days after the Release is published in the Federal Register. We will hold a conference call on Wednesday, September 6 at 3:00 pm Eastern Time to discuss this matter. The dial-in number for the call is (800) 369-1122 and the pass code is 56361. Please send an email to Stephanie Holly at sholly@ici.org to let us know if you plan to participate on the call. 1 SEC Release Nos. 33-8732, 34-54302 and IC-27444 (Aug. 11, 2006) ("Release"). The Release is available on the SEC's website at <http://www.sec.gov/rules/final/2006/33-8732.pdf>. The page numbers in this memorandum refer to the Release as printed from the SEC's website. 2 I. Summary of Revised Rules A. Disclosure of Executive and Director Compensation (pp. 17-132) According to the Release, the revised rules represent a "thorough rethinking" of the disclosure requirements for executive and director compensation. In particular, companies will be required to provide expanded tabular disclosure regarding all elements of compensation and improved narrative disclosure, in plain English, that will facilitate investor understanding of the information presented in the tables. The Release highlights that the revised rules may require disclosure of various aspects of a company's use of options in compensating its executives and directors, including any company plans or practices with regard to the timing or dating of option grants. The Release further notes that the new requirements are intended to be sufficiently broad so that they will operate effectively as

new forms of compensation are developed in the future. Disclosure regarding executive compensation will begin with a new Compensation Discussion and Analysis (CD&A), which is intended to provide material information about the company's compensation objectives and policies and to put into perspective all other compensation disclosures. The Release provides several illustrative examples of issues that would be potentially appropriate for discussion in the CD&A. As proposed, the CD&A will be filed with the Commission and thus subject to the general disclosure and liability provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934. In response to comments, the SEC also is adopting a separate Compensation Committee Report that will require the compensation committee to state, among other things, whether it has reviewed and discussed the CD&A with management. The report will be included or incorporated by reference into the company's annual report on Form 10-K. The CD&A will be followed by tables and narrative disclosure covering these areas:

- Total compensation for each of the last three fiscal years – Information about the various elements of compensation (e.g., salary, bonus, stock awards) paid to the company's principal executive officer, principal financial officer, and the three next highest-paid executive officers (collectively, "named executive officers") will be provided in a revised Summary Compensation Table. Among other changes, that table will include a new column showing the total compensation paid to each executive. A separate table will provide more detailed information about equity and non-equity awards made to the named executive officers during the last year. Narrative disclosure accompanying this section must describe any material factors necessary to an understanding of the information in the tables.
- Exercises and holdings of previously awarded equity – Two new tables will report, for each named executive officer, information about (1) the value of all equity awards that remain outstanding as of the end of the fiscal year and (2) amounts received during the fiscal year upon the exercise of options or the vesting of stock or similar instruments.
- 3 • Post-employment compensation – According to the Release, the revised rules include significant revisions to the disclosure of post-employment compensation. Two new tables will report, for each named executive officer, (1) the actuarial present value of the officer's accumulated benefit and number of years of credited service under a defined benefit plan and (2) contributions, earnings, and balances under a nonqualified defined contribution or other deferred compensation plan. Narrative disclosure will be required, among other things, to detail the potential payments and benefits to a named executive officer upon his or her termination or upon a change in control of the company. According to the Release, because of the complexity now seen with director compensation packages, the rules include a new Director Compensation Table (modeled on the Summary Compensation Table discussed above). The table will disclose, for each director, total compensation information for the most recent fiscal year. In the compensation tables for executives and directors, the amount of perquisites above \$10,000 will need to be included in the column for "all other compensation." The Release provides interpretive guidance on the factors to be considered in determining whether an item is a perquisite that must be disclosed. Business development companies ("BDCs") will have to comply with the same disclosure requirements as operating companies with regard to executive and director compensation.

B. Compensation Disclosures on Form 8-K (pp. 132-144) Currently, Item 1.01 of Form 8-K requires disclosure about a company's entry into, or amendment or termination of, a material definitive agreement entered into outside the ordinary course of business. As discussed in the Release, the 2004 amendments to Form 8-K extended this requirement to many agreements regarding executive compensation, which has had the effect of requiring companies to make real-time disclosure about compensation arrangements that do not always appear to be unquestionably or presumptively material. Under the revised rules, employment compensation arrangements will no longer be subject to the requirements of Item 1.01; instead, disclosure of such

arrangements will be combined into Item 5.02, which currently requires disclosure regarding the appointment or departure of specified officers or directors. In particular, revised Item 5.02 generally will include, among other things: (1) a brief description of any material plan or arrangement that is entered into or materially amended in connection with the appointment or departure of a specified officer or director, or any grant or award to that person in connection with his or her appointment or departure; and (2) with respect to any named executive officer, a brief description of any new material compensation plan or arrangement (or material amendment thereto), or a grant under such plan or arrangement, whether or not related to the officer's appointment or departure. With respect to the disclosure noted in (2), the rules provide a safe harbor from liability under Exchange Act Rule 10b-5 for failure to make a timely filing.

**4 C. Related Party Transactions (pp. 146-168)** The rules include significant revisions to the disclosure requirements for related party transactions, which the Release states are designed to streamline the requirements and make them more principles-based. In general, a company must disclose any transaction since the beginning of the last fiscal year, or any transaction currently proposed, in which: (1) the company is a participant, (2) the amount involved exceeds \$120,000, and (3) any related person had, or will have, a direct or indirect material interest. This requirement extends to disclosure of indebtedness, thus eliminating the current distinction between the disclosure requirements for indebtedness and other types of related party transactions. A company also must disclose its policies and procedures for the review, approval or ratification of related party transactions and identify any reportable transaction for which the policies and procedures either did not require review or were not followed.

**D. Director Independence and Corporate Governance (pp. 169-179)** The revised rules consolidate and expand the disclosure requirements regarding director independence and corporate governance. Among other things, a company will be required to identify its independent directors and to describe, for each such director, the types of transactions (other than any related party transaction already required to be disclosed), relationships, or arrangements that were considered by the company's board of directors in determining that the director is independent. The definition of independence that is applied must comply with the listing standards applicable to the company or, if the company is not a listed issuer, with the independence standards of a national securities exchange or national securities association as specified by the company. If the applicable standards also contain independence requirements for board committees, the company will be required to identify each non-independent member of the compensation, nominating, and audit committees. Under the revised rules, a company will be required to disclose information about its compensation committee similar to that currently required for its nominating and audit committees. This disclosure includes the role of any executive officers in determining or recommending the amount or form of executive or director compensation.

**E. Provisions Affecting Registered Investment Companies (pp. 122, 182-184)**

- **Proxy disclosure requirements** – The provisions in Schedule 14A concerning fund disclosure relating to nominating and audit committees, board meetings, the nominating process, and shareholder communications have been moved from Item 7 into Item 22(b). The substance of these requirements has not been altered. In addition, Item 22(b) has been revised to include disclosure regarding nominating and audit committee independence that is similar to that already required by Item 7.
- **Disclosure of director interests, transactions and relationships** – The threshold for disclosure in proxy statements and registration statements of certain interests, transactions, or relationships involving each independent director has been raised from \$60,000 to \$120,000. This change corresponds to the increase in the threshold for disclosure of related party transactions involving directors of operating companies, as described above.
- **Portfolio manager compensation** – A fund will no longer be permitted to exclude relocation plans and arrangements from its description of the structure of portfolio manager

compensation. This change mirrors the elimination of a similar exclusion for operating companies. II. Modified Proposal Relating to Non-Executive Employees (pp. 90-98) The SEC initially proposed to require companies to disclose the total compensation paid in the last fiscal year to up to three employees who were not executive officers during the period but whose total compensation exceeded that of any of the company's named executive officers. The non-executive employees would have been identified by job description and not by name. This disclosure would have been included in the narrative discussion accompanying the company's Summary Compensation Table. Most commenters addressing this provision objected to the proposed disclosure, arguing that the information would not be material to investors, the disclosure could result in competitive harm to the company, and administrative compliance could be burdensome and costly.<sup>2</sup> To address the concerns raised by commenters, the SEC is proposing to apply the provision only to employees who have responsibility for significant policy decisions within the company, a significant subsidiary of the company, or a principal business unit, division or function of the company. The Release states that responsibility for significant policy decisions "could consist of, for example, the exercise of strategic, technical, editorial, creative, managerial, or similar responsibilities." The Release goes on to explain how this standard would apply in certain circumstances, including to portfolio managers. Specifically, the Release states: Nor, as a general matter, would investment professionals (such as a trader, or a portfolio manager for an investment adviser who is responsible for one or more mutual funds or other clients) be deemed to have responsibility for significant policy decisions at the company, at a significant subsidiary or at a principal business unit, division or function simply as a result of performing the duties associated with those positions. On the other hand, an investment professional, such as a trader or portfolio manager, who does have broader duties within a firm (such as, for example, oversight of all equity funds for an investment adviser) may be considered to have responsibility for significant policy decisions.<sup>2</sup> The Institute's comment letter, which expressed the views of funds as investors, asserted that: (1) the proposed disclosure would not be meaningful to funds or other investors because non-executive employees do not perform policymaking functions; (2) these employees have little influence over their pay packages, which are generally determined by market forces; (3) the SEC should evaluate whether the disclosure would make it easier for a company's competitors to lure away its top talent; and (4) the SEC should evaluate whether any benefit to the disclosure would be outweighed by the potential administrative burdens on companies to comply.<sup>6</sup> The SEC requests comment on a range of issues, including: (1) the materiality of the information to investors; (2) whether the proposed disclosure should be required only for large accelerated filers (there are about 3500 such companies, which have market capitalizations of over \$700 million); (3) whether additional information about the employees should be required, including their names; (4) whether the SEC should define "responsibility for significant policy decisions;" and (5) the cost of compliance, which the SEC estimates as \$11 million annually if the provision is limited to large accelerated filers. Rachel H. Graham Associate Counsel